



## May 2016 – Ear to the ground

### Steady start to the fiscal

Indian stock markets seemed to be in a consolidation phase in this early part of the fiscal as global events took backstage. While corporate results (ex-banks) were largely encouraging with leading companies in IT, consumer non durables and Autos exceeding expectations, macro economic data remained tepid. Also, with the bounce in oil/commodities, the beneficial impact on macro (especially external) would start to wane in the coming quarters. Institutional flows were balanced also reflecting the narrow stock market movements (+/- 2%).

### Large caps perform better

Investors found relative value in large caps compared to mid caps. Also, perhaps a bit of catching up as mid caps have fared better these past couple of years. Our view remains that India will remain a stock specific market irrespective of market capitalisation but growth parameters will continue to favour mid caps until a full-fledged economic recovery.

### Correction to provide investible opportunities

While our base view is for positive returns from Indian equities in FY17 (as enumerated in our April newsletter), in the near term, we see timely onset and distribution of monsoons being a key determinant of market sentiment. However, we expect volatility closer to the Fed meet and Brexit vote (both in June). These could be opportunities to increase exposure to Indian stocks. We took this period as an opportunity to keep our ear to the ground and scan pockets of growth. We did meetings, calls and analyst meets spread across sectors which points to some interesting turning points. Listing some key trends observed below, in no particular order.

1. **NBFCs** – Loan books are growing at 20-50% across segments (incl. micro finance, personal finance, gold loans, SME) with improving yields & ROA. More on this later in this note.
2. **Hotels** – Recovery is underway as demand growth exceeded supply growth across the country, leading to 400-500bps improvement in occupancies. Another year like this, appearing more and more likely given low supply growth, and it will start to show in the room rates and earnings.
3. **Government schemes** – While orders may still be few quarters away, companies like VA Tech Wabag (water treatment play) hinted at some forward movement in Government's flagship schemes like Clean Ganga and AMRUT (Atal Mission for Rejuvenation and Urban Transformation) in 2016.
4. **Engineering and construction** – Order books have been increasing and not just in roads; FY17 will be a big year for order execution. In particular, there has been a good traction in the marine segment, ITD Cementation being a key beneficiary.

## Speciality Chemicals update

In the last newsletter we had talked about fluorochemicals based companies, SRF (SRF.BO; USD 1010mn) and Navin Fluorine (NAVINFLUOR.BO; USD 293mn). Given the divergent approaches which the two companies have taken, they displayed contrasting trends in Q4FY16 earnings and commentary. SRF met expectations on specialty chemicals but the FY17 growth guidance of 15-20% was weighed down by high dependence on global agrochemicals, which is still reeling from a slowdown although there are hopes of a revival later this year. Meanwhile, Navin's asset-light CRAMS model focused on pharmaceuticals end-use displayed robust ramp-up resulting in significant profitability gains. Although valuation discount of SRF (12x FY17E) vs. Navin (18.5x FY17E) now adequately reflects the agrochemical cyclical and capital allocation issues of former, the divergence in stock performance could continue in the short run.

## NBFCs – Moving in to the vacuum

Given the vacuum created by the PSU banks and some of the stressed private sector banks, both in the credit markets as well as the sample set of investible ideas in financial services (still a large component of the benchmarks), NBFCs have cashed in. Loan books/AUMs are growing at rapid pace; infact the ones focusing on the bottom of the pyramid are growing at 40-60%. Meanwhile, changes in funding mix and lower interest costs are feeding into the spreads and net interest margins of NBFCs. The combination has led to healthy expansion in ROEs, now in the 15-20% range for some, with potentially more to follow. From a 6-12 month perspective, we see greater valuation upside in (i) gold loan NBFCs (viz. Muthoot, Manappuram) and (ii) embedded value plays (viz. ABNL) vis-a-vis the (i) cyclical recovery & monsoon beneficiaries (viz. M&M Financial, Shriram Transport) and (ii) the newly-listed MFI-to-be-small banks (Equitas, Ujjivan). The chart below depicts the projected ROE vs. P/BV for FY17 for the NBFCs in our consideration set.

